H.R. 4773, LEGISLATION ON THE SECONDARY MARKET FOR SBA GUARANTEED LOANS

HEARING

BEFORE THE

SUBCOMMITTEE ON TAX, ACCESS TO EQUITY CAPITAL AND BUSINESS OPPORTUNITIES

OF THE

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WEDNESDAY, FEBRUARY 29, 1984

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON TAX, ACCESS TO EQUITY
CAPITAL AND BUSINESS OPPORTUNITIES,
COMMITTEE ON SMALL BUSINESS,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:30 a.m., in room 2359-A, Rayburn House Office Building, Hon. James R. "Jim" Olin (acting chairman of the subcommittee) presiding.

OPENING STATEMENT OF ACTING CHAIRMAN OLIN

Mr. OLIN. The hearing will come to order.

This is a hearing of the Subcommittee on Tax, Access to Equity Capital and Business Opportunities of the Small Business Committee of the House of Representatives. I am acting in the place of subcommittee Chairman Henry J. Nowak, who is snowbound in Buffalo. We may have a few other people who have had that same problem today. We appreciate those of you who have shown up.

I will read the chairman's prepared statement prior to getting into the hearing itself.

The hearing today is on the subject of the secondary market for SBA-guaranteed loans. The hearing today will discuss H.R. 4773, legislation designed to facilitate a vibrant secondary market for SBA-guaranteed loans. The legislation has been introduced as an outgrowth of an earlier investigatory hearing held by this subcommittee last September. Joining Mr. Nowak as original cosponsors of the bill are 12 members of the Small Business Committee, including every member of this subcommittee.

There are revolutionary changes occurring in the financial markets of our country. We are in the era of bank deregulation, the so-called nonbank bank, and the financial services supermarket. With the changes occurring all around us, the legislation is designed as an important means of insuring that small business continues to have access to debt capital at reasonable cost.

In general, H.R. 4773 will foster the development of a close working relationship between private and public interests. This would be accomplished through the utilization of the basic SBA-guaranteed-loan program as its foundation. Authorized by section 7(a) of the Small Business Act of 1953, the guaranteed-loan program enables lenders to make long-term loans to smaller firms that otherwise might not be available. Through the guaranteed-loan program,

small businesses have received in excess of $16 billion in financing over the past 6 years.

The secondary market is an integral component of the 7(a) guaranteed-loan program. In operation since 1972, the secondary market brings private and public interests together by enabling lenders to sell the guaranteed portion of an SBA loan to an investor. This process provides the lender with an increase in liquidity and, as a result, enables it to make further loans to the small business community. In fact, a recent issue of INC. magazine calls the secondary market "probably the most significant contribution that SBA has made to small business capital formation."

Nevertheless, the secondary market for SBA-guaranteed loans is not widely utilized, nor has it reached its full potential. One estimate suggests that less than 25 percent of the 7(a) loans are currently sold through the operations of the secondary market.

H.R. 4773 builds on the inherent strengths of the guaranteed-loan program by providing for certain technical improvements in the operations of the SBA Office of Secondary Market Operations. Specifically, H.R. 4773 would permit the pooling of SBA-guaranteed loans in large homogeneous certificates. These pooled loans could then be offered to institutional investors in an analogous way to the operations of the secondary market for mortgages.

The second major provision of this bill is designed to facilitate a more effective oversight of the SBA secondary market program itself. This latter provision mandates that the SBA Administrator develop such administrative procedures as are necessary for the promotion and effectiveness of the program.

We have as witnesses today three gentlemen, Robert Schiffer, managing director of Morgan Stanley & Co.'s mortgage-backed securities unit; Gordon Watson, director of marketing and sales, banking division of Merrill Lynch, Pierce, Fenner & Smith; and E. Patric Jones, senior vice president of Hyde Park Bank.

In the interest of time, since we are going to have to terminate somewhere around 11 a.m. or a little bit after to attend a caucus meeting in the House Chamber, I would like to ask you three gentlemen if you would come forward as a panel and then we will take each of your testimonies and have questions at the end of the three statements.

Your complete statements will be made a matter of record. You may read your statements or summarize them. In the interest of time, perhaps we might prefer a summary, and then we can get at the essence of what you have to present. Handle it in any manner you prefer, but keep in mind we have some limitations on time.

I will call you in the order that you appear on my sheet here. Mr. Gordon Watson is first.

TESTIMONY OF GORDON R. WATSON, DIRECTOR OF MARKETING AND SALES, BANKING DIVISION, MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

Mr. WATSON. Thank you, Mr. Chairman, and members of the subcommittee, for giving me another opportunity to appear before you and express Merrill Lynch's views on a subject that I think is very important to the small business community. It is my pleasure

to address H.R. 4773, a bill authorizing the pooling of SBA 7(a) guaranteed loans.

I would like at this time to offer with my testimony my prepared statement, which you have already received.

Merrill Lynch's interest and involvement in the secondary market for SBA 7(a) guaranteed loans began approximately 8 years ago. During this 8-year period, we have had a continuous commitment to working with the SBA in developing enhancements to the secondary market program. I have served a 2-year term as the first chairman of the Government Guaranteed Loan Dealers Association and also had the pleasure of serving as a member of the Small Business Committee on Capital Access, which is the committee that made all the recommendations about 1½ years ago that dealt with the pooling issue we are addressing today.

Merrill Lynch's unwavering commitment to the secondary market of the 7(a) guaranteed-loan program has contributed significantly to what is viewed by many as one of the most successful aspects of the SBA's program.

Mr. Chairman, Merrill Lynch has also had extensive experience with pooled instruments such as the instruments which are created by H.R. 4773. Merrill Lynch was a pioneer in the evolution and development of the Government National Mortgage Association mortgage-backed securities market. Through Merrill Lynch Mortgage Capital, Inc., we are recognized as one of the leading securities firms in the rapidly broadening field of mortgage-backed securities.

The evolving activities within the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and GNMA, in concert with the securities industry, have created a market that is today one of the most dynamic in existence. We believe acceleration of mortgage-backed securities activity, both in the public and private sector, is beginning to have a profound beneficial effect on both the mortgage industry and ultimately prospective borrowers. With this background, I believe Merrill Lynch has a unique and important perspective on the pooling of SBA 7(a) guaranteed loans.

Merrill Lynch supports H.R. 4773 as it provides a viable mechanism for the pooling of SBA 7(a) guaranteed loans. We believe that of all the recommendations made by the Small Business Committee on Capital Access, the pooling concept is the most important proposal. There is ample evidence in the marketplace to demonstrate that creation of an effective pooling mechanism is the single most important step toward the development of a secondary market, with the efficiencies necessary to provide small business owners greater ability to access capital markets at competitive rates and terms.

We recognize that in recent years there has been an improvement in the small business owner's ability to finance his business. Provisions in the Economic Recovery Act increased substantially a small business owner's internal means of financing through accelerated cost recovery and other tax reforms. Additionally, the increasing flow of venture capital to small businesses has provided many independently owned businessmen with a new source of equity money. But neither the improvements in the Tax Code nor the increased availability of venture capital improve long-term fi-

nancing opportunities such as the pooling of 7(a) guaranteed loans would do.

We recommend that Congress provide SBA with the enabling legislation authorizing the agency to establish a loan pooling and packaging program that would combine SBA-guaranteed loans into large, homogeneous packages making it feasible for the Nation's largest institutions to purchase SBA-guaranteed loans in quantities appropriate for their size. With more financial institutions active in the origination and purchasing of SBA-guaranteed loans, the secondary market would expand, the rate of return required on these investments would be reduced, and ultimately the cost borne by the small business borrower would be reduced.

Additionally, again because of increased institutional involvement in the SBA's secondary market, pooling would increase the flow of capital from our Nation's money centers to those geographic areas where there is demand for long-term debt. In sum, pooling would dramatically improve the efficiency of SBA's secondary market to the benefit of the small business borrower.

I would like to address an issue, the resolution of which I believe will ultimately determine the economic viability of SBA's secondary market program, even if legislation authorizing pooling is enacted into law. My point is primarily that the secondary market really only becomes efficient and therefore effective when it has demonstrated a degree of continuity, when it has reached a level of outstandings and volume that will provide adequate liquidity, and when it has reached a certain critical mass intrinsic to a highly visible market that can be accessed by large and small institutions alike. In this regard, the administration's budget request of nearly $3.3 billion for SBA's business loan investment fund has been well received by many as an indication that the 7(a) guaranteed-loan program and the secondary market will be allowed to function and grow.

There were several other points raised in my written testimony reemphasizing issues which I think are of major importance in addition to pooling, but for the sake of time I will dispense with discussing those at this time.

I appreciate having the opportunity to be here and I am open for any questions. Thank you.

[Mr. Watson's prepared statement follows:]

PREPARED STATEMENT OF GORDON R. WATSON, DIRECTOR OF MARKETING AND SALES, BANKING DIVISION, MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

Mr. Chairman, my name is Gordon Watson. I am director of Marketing and Sales in the Banking Division of Merrill Lynch Capital Markets, Inc. It is my pleasure to again appear before this Subcommittee to discuss Merrill Lynch's role in the secondary market for Small Business Administration (SBA) loans and in particular to address H.R. 4773, a bill authorizing the pooling of SBA 7(a) guaranteed loans.

Merrill Lynch's interest and involvement in the secondary market for SBA 7(a) guaranteed loans began approximately eight years ago and has grown since then to the point where a new group was formed within Merrill Lynch three years ago called the Federal Financing Group. This Group is responsible for all trading and financing activities relating to government guaranteed programs which included the SBA 7(a) guaranteed loan program.

During this eight year period we have had a continuous commitment to working with the SBA in developing enhancements to the secondary market program. I served a two-year term as the first Chairman of the Government Guaranteed Loan Dealers Association and also had the pleasure of serving as a member of the Small

Business Committee on Capital Access. Additionally, I was involved in the initial development of SBA's fiscal agency program which is now being administered by the Bradford Trust Company.

Our Federal Financing Group in New York and a network of Account Executive specialists throughout the country are actively involved with each step of SBA guaranteed loan transactions. Merrill Lynch underwrites the guaranteed portions of the loans temporarily taking title to them and tries to make a profit on the loans by reselling them to investors (e.g. pension funds) at a mark-up. In reselling the loans we have underwritten, we have signed without recourse our right, title and interest to the purchasing investor.

Merrill Lynch's unwaivering commitment to the secondary market of the 7(a) guaranteed loan program has, we believe, contributed significantly to what is viewed by many as one of the most successful aspects of the SBA's programs.

By way of background, Mr. Chairman, Merrill Lynch has had extensive experience with pooled instruments such as the instruments which would be created by H.R. 4773. Merrill Lynch was a pioneer in the evolution and development of the Government National Mortgage Association (GNMA) Mortgage-Backed Securities Market. Through the years we were instrumental in the development of the initial primary market and subsequently the actual GNMA secondary market which has become one of the most liquid U.S. government agency markets in existence. Through Merrill Lynch Mortgage Capital, Inc. we are recognized as one of the leading securities firms in the rapidly broadening field of mortgage-backed securities. The evolving activities within Fannie Mae (the Federal National Mortgage Association), Freddie Mac (the Federal Home Loan Mortgage Corporation), and Ginny Mae (GNMA) in concert with the securities industry have created a market that is today one of the most dynamic in existence. We believe acceleration of mortgage-backed securities activity both in the public and private sector is beginning to have a profound beneficial effect on both the mortgage industry and ultimately prospect borrowers. With this background, I believe Merrill Lynch has a unique and important perspective on the pooling of SBA 7(a) guaranteed loans.

Merrill Lynch supports H.R. 4773 as it provides a viable mechanism for the pooling of SBA 7(a) guaranteed loans. We believe that of all the recommendations made by the Small Business Committee on Capital Access, the pooling concept is the most important proposal. There is ample evidence in the marketplace to demonstrate that creation of an effective pooling mechanism is the single most important step towards the development of a secondary market with the efficiencies necessary to provide small business owners greater ability to access capital markets at competitive rates and terms.

Certainly we recognize that in recent years there has been an improvement in a small business owner's ability to finance his business. Provisions in the Economic Recovery Tax Act increased substantially a small business owner's internal means of financing through accelerated cost recovery and other tax reforms: Additionally, the increasing flow of venture capital to small concerns has provided many independently owned businesses with a new source of equity money. But neither the improvements in the tax code nor the increased availability of venture capital improve long-term debt financing opportunities as the pooling of SBA 7(a) guaranteed loans would do.

We recommend that Congress provide SBA with the enabling legislation authorizing the agency to establish a loan pooling and packaging program that would combine SBA guaranteed loans into large homogeneous packages making it feasible for the nation's largest institutions to purchase SBA guaranteed loans in quantities appropriate for their size. With more financial institutions active in the origination and purchasing of SBA guaranteed loans the secondary market would expand, the rate of return required on these investments would be reduced, and ultimately the cost borne by the small business borrower would be reduced. Additionally, again because of increased institutional involvement in the SBA's secondary market, pooling would increase the flow of capital from our nation's money centers to those geographic areas where there is demand for long-term debt. In sum, pooling would dramatically improve the efficiency of SBA's secondary market to the benefit of the small business borrower.

Merrill Lynch has not analyzed the variety of organizational structures that could be utilized to create pools of SBA guaranteed loans. Therefore, we are not prepared to recommend a specific structural methodology to create this marketplace. We do, however, see three possible options.

1. Expand GNMA's authority to buy non-mortgage collateral so that they might act as the pooling agent and subsequent issuer of the securities.

2. Develop the infrastructure within the SBA, as would be authorized by H.R. 4773, to pool 7(a) guaranteed loans or to approve of pools developed by private sector companies. We do believe H.R. 4773 gives SBA the necessary authority to pool loans or approve of pools.

3. Hire a private sector company to perform these functions.

Whatever format is finally adopted, the pooling agent would have to accept bids from intermediaries such as investment banking firms and commercial banks which would purchase the pools for resale to investors. And the pooling agent would need to obtain similar maturities for each respective pool and develop a consistent method of calculating interest. Each pool formed would also have to utilize a single fiscal and transfer agent.

In closing Mr. Chairman, I would like to address an issue, and several collateral problems, the resolution of which I believe will ultimately determine the economic viability of SBA's secondary market program even if legislation authorizing pooling is enacted into law. My point is that a secondary market really only becomes efficient, and therefore effective, when it has demonstrated a degree of continuity, when it has reached a level of outstandings and volume that will provide adequate liquidity, and when it has reached a certain critical mass intrinsic to a highly visible market that can be accessed by large and small institutions alike. In this regard, the Administration's budget request of nearly $3.3 billion for SBA's Business Loan Investment Fund has been well received by many as an indication that the 7(a) guaranteed loan program and the secondary market will be allowed to function and grow.

Merrill Lynch also offers the following recommendations, in part reemphasizing several of the recommendations of the Small Business Committee on Capital Access, geared toward enhancing secondary market operations with the ultimate goal of providing increased definable benefits to the small business community.

Loan guarantee processing at SBA district offices should be improved as the inability of these offices to consistently provide timely and professional service in administering requests for loan guarantees is a major impediment to greater lender involvement in the loan guarantee program and ultimately has a negative impact on the development of greater liquidity in the secondary market. The Capital Access Committee Report addressed the issue in suggesting a new preferred lending program which is currently being tested on a pilot program basis by the SBA.

In order to increase the appeal of the secondary market and ease the use of it, steps to standardize SBA loans should be taken. The well-known success of the GNMA secondary market is largely attributable to the standardization of the underlying program mechanics. With a more homogeneous product, investor comprehension of and involvement in the secondary market can be boosted significantly. Consequently, we recommend that the SBA do the following:

Mandate the use of a uniform mandatory peg rate on variable rate loans, specifically the "low New York prime rate" as published in the Wall Street Journal or other widely distributed sources of information.

Require lenders to stipulate their method of accruing interest using either of the two generally accepted methods of calculating interest (on a 360 or 365 day basis).

Require the fiscal and transfer agent to remit interest due on a standard accrual calculation allowing the investor of an SBA guaranteed loan to better calculate the anticipated return on the investment.

Problems with timely payment of principal and interest have significantly reduced investor interest in SBA loans. Without a cash flow that can be reasonably estimated, the investor has a hard time analyzing the value of an investment in an SBA loan versus the value of alternative investments. A purchaser of an SBA loan may experience as much as one month delay in receiving payment. To avoid this problem we suggest that the SBA require lenders or a fiscal and transfer agent (FTA) to remit principal and interest on a timely basis. We understand this is not being done on a limited voluntary basis by the FTA with great success. If it is too unwieldy for lenders to remit timely payments, then SBA should establish an escrow fund at the FTA out of which payments could be made. The fund would be secured largely by the SBA's own guarantee. We also suggest that the SBA remit more timely payments in the event of borrower default. At present 120 or more days may elapse between the last payment made by the borrower and the date when remaining principal and accrued interest is refunded to the investor. Overall, reduction in the risk of repayment delays could help reduce the rate of return required by investors and ultimately the borrowing costs faced by small businesses.

In order to facilitate orderly closings of secondary market transactions the SBA must expedite its procedures for approving the sale of loans. Particularly, it should eliminate the time delays attributable to "second looks" at loans presented for ap-

proval. These delays discourage lenders and investors from using the secondary market and divert limited SBA resources from program oversight.

We endorse the imposition of a ceiling on the servicing fees received by lending institutions which originate loans with the intent of utilizing the secondary market. It is with some reluctance that we approve of a measure that involves further government regulation. However, as mentioned earlier, it is essential that the benefits of a more efficient secondary market be passed on to the borrower. We would gladly endorse any other less structured method that would provide this pass-through of benefits to the primary benefactor of the SBA's activities—small business.

It must not be forgotten that a healthy balance between investor needs and required flexibility of borrowers and lenders is necessary in order for a viable secondary market to exist. We, therefore, recommend that the following issues, which are critical to investors, be addressed: (i) the institution of some form of pre-payment protection, (ii) limitations as to refunding or repurchases of loans by originating lenders, and (iii) the restriction of sales of variable rate loans at excessive premiums by originating lenders.

Finally, Merrill Lynch recommends that the SBA assume greater oversight responsibility in the secondary market as clearly outlined in the recommendation section of the Report to the Congress by the General Accounting Office (GAO/RCED-83-96; April 25, 1983). The SBA should develop procedures to clarify and implement its goals and objectives in promoting the secondary market; immediately institute a fully computerized record keeping system for 7(a) loans, thereby helping Congress carry out its program oversight functions; and develop a strategy for using the secondary market to offer small businesses the option of fixed-rate financing.

In conclusion, Merrill Lynch fully endorses H.R. 4773 and we stand ready to assist the Small Business Administration to develop the structure and mechanics necessary to insure that the pooling of SBA guaranteed loans provides the benefits outlined above.

Mr. OLIN. Thank you, Mr. Watson.

We will hold the questions until we hear the other two witnesses. Mr. Schiffer, would you like to take the mike next.

TESTIMONY OF ROBERT F. SCHIFFER, MANAGING DIRECTOR, MORTGAGED BACKED SECURITIES UNIT, MORGAN STANLEY & CO.

Mr. SCHIFFER. Mr. Chairman, my name is Robert Schiffer. I am the managing director of Morgan Stanley Co. My basic area of responsibility is the origination, packaging, trading, and distribution of all mortgage-related products, and those Government-guaranteed-or-insured products such as title XI's, SBA's, and so forth.

It is again my pleasure to appear on the Hill to basically discuss how the private sector in my view can participate, and participate in a larger way with the type of programs that, although they have social significance, could, with some slight changes and different authorities given, benefit the borrower, to effectively give us a secondary market which I feel would not only lower rates but also be less of a burden on the Government, per se.

My interest and involvement in this type of pooling concept, which is so ably proposed in H.R. 4773, goes back to the late 1960's, when I had the honor and distinct pleasure of acting as an adviser from the Wall Street community to HUD, specifically Fannie Mae and the newly conceived GNMA, so I guess I'm kind of a grandfather figure in the pooling concept in the mortgage business.

I would like to basically state that I was one of the founders of the original GNMA Dealers Association. I had the pleasure of acting as chairman to an organization called the Government Guaranteed Loan Dealers Association, which Mr. Watson founded. Then he passed on the gavel to me. Therefore, I agree very much

with Gordon's testimony and consequently will not repeat any of that.

But I think probably it would be very good to review briefly the evolution of GNMA from the early days until now, and demonstrate, hopefully, to the subcommittee and your constituents that it has set a very useful example which is probably one of the more successful examples in Government. It may even be a little bit embarrassing because unlike some of the social programs, it probably makes money, and that doesn't make it a bad program. But it is something that can be done effectively.

I hesitate to use the term "insurance," but in the context I may occasionally slip into it. I want you to understand that, although it is a guarantee program, per se, it also effectively can be handled in a way where there is benefit added for the price. That, to me, I think goes along with the current administration's desires and certainly, I am sure, the desires of this subcommittee.

I would like to discuss, number one, how GNMA functions, what the benefits are that can accrue from the pooling of these loan guarantees, and how perhaps some of the structures can come out—although I believe that that already has been discussed by Mr. Watson.

First of all, effectively GNMA charges, per se, 7 basis points on a pool of mortgages. There is, in fact, a Treasury guarantee. But to me, it acts somewhat as an insurance program. The Treasury, through GNMA, guarantees the timely payment of principal and interest, charges 7 basis points off the coupon, and effectively over the last 14 years has issued and guaranteed some $200 billion worth of securities. Now, this is an amortizing instrument, so right now there is about $186 billion outstanding, but it has probably been one of the most beneficial and, I think, effective market instruments that has been developed for quite some time.

As to liquidity, I would say offhand that probably the FHA/VA mortgages that go into the GNMA securities, which now is in excess of 95 percent of all FHA/VA mortgages, effectively go into GNMA securities. It is a conduit that has reached the ultimate of efficiency. As I say, the amount of foreclosures, the amount of dollar drain on the Treasury, or on GNMA itself, is absolutely none.

There are some social programs that were designed to stimulate multifamily housing that involved lending 7½-percent money. Well, as you know, with what we have gone through, we're still at 7½ percent on the multifamily housing. That, in itself, is a drain. But that is a social program that was set up for a particular purpose. The single-family market which goes into the GNMA, has reached an efficiency, a trading volume, that probably equals itself every year. It is totally accepted as a Government, it is traded as a Government by buyers, by investors, which is exactly where we want to get. It probably trades somewhere around 200 basis points less cost to the borrower than a conventional mortgage of even somewhat the same caliber, because of the 7 basis points insurance, that is effectively utilized by GNMA.

Now, how do we do that? Well, in the case of GNMA, you take your FHA mortgages and an issuer issues $1 million worth of GNMA's against pooled FHA or VA mortgages. Well, in the case of

SBA, I doubt if an original issuer could come up with $1 million. But, for example, on mobile homes, which are guaranteed by GNMA, there is a $500 million pool.

Somewhere there is a number, whether it's a quarter-of-a-million or half-a-million dollars worth of pooling, that could be done on small business loans. This requires several things. It is going to require, number one, a standardization of some documents, which by the way the SBA has the capability of doing very well. I think that the Administrator and the staff of SBA have the ability and the people currently on board to administer such a program. Coming down to the finite fee, which is almost an actuarial function of what is given versus what is guaranteed, it is my feeling that this GNMA example can be followed.

Now, the investors have demonstrated and have already been preeducated by the GNMA community, so that after 3 or 4 years, especially now, where we're tapping the untraditional funds, the pension plans, the insurance companies, the nontraditional investors, it is not all going to S&L's, thrifts, savings banks, where the original mortgage market was. As a matter of fact, you might say that the first couple of years of GNMA was basically a failure. It was not a failure in the fact that it issued a great deal of volume, but the volume was going right back to the traditional investors, the S&L's, the thrifts, and so on. Now, of course, with the changes in the thrift community, we have tapped into the real players, the money managers, specifically.

I think you will find that last year the major money managers that outperformed the market, their basic peers, were those that primarily invested in Government-guaranteed mortgage paper. Now, when that report card comes out on those money managers, I think what you will find is that more and more nontraditional money managers will start to use the mortgage paper. There is no reason at all why the SBA and other programs—but specifically SBA—can't tap into that market. It is a ready market. It has taken some of us 14 years to build it to where it is now. Frankly, it is my opinion that within 1 year, with the participants that are involved—the Merrill Lynch's, the banks, the Morgan Stanley's, the Wall Street community—you will find that it is something we can jump on to the tail of and effectively increase by far the participation in small business loans.

You can well understand how the $33,000 loan, the $40,000 loan, and its resulting paperwork—which is literally a packet of paper, which is precisely like a mortgage—is just not functional in the market. Today, people buy by hundreds of thousands, by millions. That's the way it is. That's the way the market is. But these investors are there and they are ready to support it. I think we should use the GNMA guidelines that have been set forth. It is foolish for us not to.

Now, the benefits are, I think, it is a substantially lower rate to the borrower, because the investors, with an efficient secondary market, in a pool of reasonably assured loans will in fact take a substantial lower yield in order to feel that their money is safe. We should just take advantage of it, without the inefficiencies of the single loan transaction. For example, a new program coming out that you might want to look into is the new GNMA II, where effec-

tively there is only one check issued, no matter what number of pools you own. They did it. It has already been done in a Government agency and there is no reason why it can't be done by somebody else. Let's use them as an example and benefit from them.

Now, how should it be structured? There are people here who I am sure are much better qualified than I to talk about that. All I know is, GNMA right now operates with a minimal staff, with the amount of money outstanding and the amount of work that they do. I must confess, it's an extremely efficient staff. The fact is, a minimal staff would therefore lead me to believe that the SBA people effectively can handle the business that is requested here. As a matter of fact, what we will find out is it's going to be a lot easier and much more efficient.

Thank you. I know that's rather brief, but I think that probably fits in with your plans today. Thank you very much for having me.

Mr. OLIN. A very good statement, Mr. Schiffer. We appreciate that. We might have a question for you when we get finished.

Mr. Jones.

TESTIMONY OF E. PATRIC JONES, SENIOR VICE PRESIDENT, HYDE PARK BANK & TRUST CO.

Mr. JONES. Thank you, Mr. Chairman. I am very much aware of your 11 a.m. deadline——

Mr. OLIN. Well, it's not exactly 11. [Laughter.] I have a little give on that.

Mr. JONES. I will, nevertheless, submit my prepared statement and just do this very briefly.

Mr. OLIN. Fine.

Mr. JONES. Our bank, the Hyde Park Bank, is a very staunch supporter of the SBA loan program. We think it has been one of the more efficient and effective Government programs.

Our bank is very much an urban bank. We are located on the south side of Chicago, where our primary market is small business. For many years, we have been a leading lender to small business and our support has come directly through bank loans and through our MESBIC subsidiary, the urban fund.

We applaud the committee's efforts to broaden and enhance the secondary market process. We think this is an excellent example of Government working with the private sector initiative, working toward a common good. We think it is an exemplary use of taxpayer dollars.

To a lender, the secondary market is of primary interest during periods of tight liquidity and high loan demand. That issue of liquidity becomes much more important with the smaller banks. The secondary market allows these lenders to leverage their limited capital and to make more loans than would originally be made.

We have all gone over the benefits to small business. I would simply make two points. One, I think the secondary market's existence and potential is not well known. I think a continuing education program is essential. In the past, SBA's Office of Advocacy has done a significant job in the information process, and I think we need to do more in the area of the secondary market.

We support the idea of a centralized fiscal transfer agent. Small business has proven itself as an efficient producer of GNP, a prolific generator of new jobs, and a constant source of tax revenues. We applaud the committee's efforts in supporting that movement.

I will answer any questions that you have.

[Mr. Jones' prepared statement follows:]

PREPARED STATEMENT OF E. PATRIC JONES, SENIOR VICE PRESIDENT, HYDE PARK BANK & TRUST CO.

Good morning, Mr. Chairman and members of the Subcommittee. I am E. Patric Jones, Senior Vice President of Hyde Park Bank & Trust Co. of Chicago, Illinois. I am delighted to be invited to comment on The Secondary Market for SBA Guaranteed Loans.

Our bank is a staunch supporter of the SBA Guaranteed Loan Program. Certainly, it has proven to be one of the more effective government programs. Thousands of small businesses have survived and prospered through financing that would not have been available to them otherwise.

Hyde Park Bank is very much an urban bank. Located on the southside of Chicago, our primary market is small business. For many years, we have been one of the leaders in financing small business. While we are not a minority-owned bank, we have since the 1960's placed a special emphasis on developing minority businesses. Our efforts in this regard have included direct bank loans and investments through our MESBIC subsidiary, The Urban Fund.

Many of our minority and non-minority business loans could not have been made without the SBA 7(a) Guarantee Program.

We, however, make many many loans without the SBA guaranty. Presently, less than 5% of our $100 million portfolio is SBA guaranteed. This number does not include the guaranteed loans in the portfolios in the four other banks which make up our five bank group.

We applaud your efforts, Mr. Chairman to broaden and enhance the secondary market process for SBA guaranteed loans. This process, in my opinion, is an efficient example of a government and private sector initiative working toward a common good. Our economy, in general, and thousands of small business people in particular, benefit from the private sector involvement in this leveraging process. It is, in my opinion, an exemplary use of tax payer dollars.

It is not an example of government assuming a private sector role. Government, in this instance, is inducing the private sector to assume a role that heretofore was non existent. And ultimately, it should mean lower interest rates to the small business borrower. Rates will be a function of the credit market.

You have here today enthusiastic support of the secondary market process from a bank which has never used the secondary market. We have not, to date, needed the liquidity. Our over-all demand for loans has been down significantly for a couple of years. We think it is a direct result of the depressed economy. With an upturn in the economy, we expect the demand to rise. Right now, though, we are aggressively seeking additional loans.

To a lender, the secondary market is of primary interest during periods of tight liquidity ("cash crunches") and high loan demand. When a bank has excess liquidity, there is less need for the secondary market. The smaller the bank, however, the more important is the liquidity issue. The secondary market allows these lenders to leverage their limited capital and to make more loans than would ordinarily be possible.

A possible secondary advantage to the lender is the potential in some cases to increase the effective yield on the loan portfolio.

The benefits to the small business borrower are significant: First, capital is available for loans that otherwise would not exist. This is particularly true in areas where the banks are small.

Second, the secondary market provides the lender a vehicle to make fixed rate loans which would otherwise be limited by a lenders' need to balance long term fixed rate loans with short term variable rate deposits.

It is a very valuable program.

As an active SBA certified lender and as a potential seller in the secondary market, we have found the SBA to be supportive and open to new ideas for improving the whole program.

We think the secondary market's existence and potential is not well known. A continuing education program is essential. In recent years, the SBA's office of Advo-

cacy has done an excellent job in the education and information process. Many more banks, big and small, should be made aware of the efficiencies in the 7(a) Guarantee Program in general and the secondary market in particular.

We support the idea of a centralized Fiscal Transfer Agent as a way of streamlining the loan administration process. That, in itself, would be an added incentive to lenders and investors.

Small business has proven itself as an efficient producer of GNP, a prolific generator of new jobs, and a constant source of tax revenue.

The SBA under Jim Sanders' administration has taken many initiatives to benefit small business. We bankers are appreciative. We particularly applaud you, Chairman Nowak and members of the committee, for your initiative in seeking long range solutions to fundamental problems.

Mr. OLIN. Thank you very much, Mr. Jones. You really got under the deadline. You had 5 minutes and only took up 2. It was exemplary.

It's interesting that we have three witnesses here who are totally supportive of the venture. It makes you wonder why we haven't done this long before. Let me ask a couple of questions.

Mr. Schiffer, you pointed out that you feel this market can develop about as fast as the GNMA market did if treated about the same way, and that GNMA really developed the concept. Your feeling is that you would get very rapid participation.

Mr. SCHIFFER. I think within a 12-month period, sir, if not sooner.

Mr. OLIN. Do either you or Mr. Watson see any problems with the marketability of SBA paper in this respect, or what might hold it back?

Mr. WATSON. Well, in its current state, marketability is a very clear question, because it is not marketable. They are more akin to private-placement transactions and there is not the liquidity in the marketplace that is necessary for a large, active market. The pooling concept gets very much at that issue. When you can get enough volume in the marketplace, then institutional investors have a sense that they can not only sell the investment they have made, but buy it as well.

Mr. OLIN. So pooling is really the critical point in all of your minds?

Mr. SCHIFFER. It becomes a size situation.

Mr. OLIN. This opens up the market then to so-called money managers who deal in larger quantities.

Mr. WATSON. There's another thing, too. I think in the last 1½ years we have the benefit of the mortgage market, the evolution of the mortgage market to look at, so we have got a historical reference point. In the last 1½ years there has been a literal explosion in the mortgage market as it relates to secondary-market activities, both in the form of GNMA, other agencies, and also direct transactions.

It's an issue where you reach a certain critical mass and there is a certain understanding of the underlying assets that you're dealing with. Once you reach that level, you witness what we are witnessing now in the mortgage market, which is clearly an explosion in volume and activity.

Mr. OLIN. What level of pooling do you think will turn out to be the optimum amount? Do you have any feel for that?

Mr. SCHIFFER. I would like to see one-half million dollars, but we may find that $250,000 may be the number. But I would like to see half a million dollar packages myself.

Mr. WATSON. Is the question the unit size or the total, the mass necessary to——

Mr. OLIN. I was asking the unit size.

What about the total volume, since you brought that up? Is the total volume of the SBA activity going to be sufficient to come up with a reasonable amount?

Mr. SCHIFFER. I believe, sir, that you will find that the volume of the SBA will basically increase because of the lower rates. In other words, what will happen here, assuming that the world is all motherhood, and apple pie, and all the things I am predicting come true, the base assumption, if there were a corresponding drop in rates, using the mortgage market as an example, it's 100 or 200 basis points, which is quite a bit. As you know, on any amortizing instrument, the curve is rather sharp. What your monthly payments are on a house at 12 percent and what they are at 16 percent is not 50 percent higher; it's probably 100 or 150 percent higher. Consequently, I think you will find on a small business loan that a corresponding drop in rates will, in fact, create an atmosphere where the benefits to the small business community will be substantially greater and, therefore, they will be able to have lower rates.

The issuing banks, such as the Hyde Park Bank, will be able to effectively get into the market and do more, be of more benefit to their small business community, because they will have the advantage of being able to lend at a more competitive rate because they, in turn, will be released from their commitment, if they choose.

Mr. OLIN. Would you agree with that, Mr. Jones?

Mr. JONES. In general, yes, I would. I don't know that we would see any immediate drop in rates. But I think with the secondary market there are some immediate advantages. One is that an issuing bank is able to make longer term loans right away, and the issuing bank is able to make fixed-rate loans if they know they can sell them and don't have to be confronted with the issue of balancing their short-term variable rate deposits with long-term fixed-rate loans. That's an immediate result.

Mr. SCHIFFER. Perhaps more banks would be able to issue also who are not doing it now.

Mr. OLIN. I have a written question here that I would like to get some response to.

Do you know of any situation in which an investor would not buy an SBA loan on the secondary market solely because there was confusion as to whether the full faith credit of the Federal Government had passed through to the new holder? Is there any problem in that area?

Mr. SCHIFFER. Well, again, let's go back to the mortgage market. You have got an FHA/VA loan which already has a type of a Government guarantee on it. Then on top of that, you have another guarantee, which is the timely payment of principal and interest from GNMA. There again, I think, if anything, I'm not saying it will never come up—but the question becomes a moot one because I think if the structure that we're using here is adopted, the educa-

tion process is already done. I feel that you will find the same types of investors are going to be the players.

As a matter of fact, no more than 2 weeks ago I had a very disheartening thing happen. One of the money managers who, in fact, I didn't even know had small business loans, brought in his little packages, and gave me his list of security holdings and asked me to please contact somebody to sell his small business loans. That's the wrong way. All of a sudden he's becoming the seller. He had $10 million of this, $27 million of that, and then he had $33,000 in the fish market. He finally said get rid of them, I don't want them around. It didn't matter what his yield was. That's a move the wrong way.

Consequently, if I could have taken those loans and somehow pooled them in a timely payment-type security, he would have been delighted and would have kept them and not been a burden on the market.

Mr. OLIN. Let me ask one more, and I'll try Mr. Watson on this one.

Currently, SBA-guaranteed loans are not processed through the Federal Financing Bank at the Treasury. Under the guise of streamlining SBA market activities, should SBA-guaranteed loans and/or SBA secondary market activities be subject to oversight by the Federal Financing Bank?

Mr. WATSON. Did you say subject to oversight by the Federal Financing Bank?

Mr. OLIN. That's what my question says; yes.

Mr. WATSON. I'm not sure what that means. The SBA is in the process and has been in the process of developing a good, sound relationship between itself, the lending community, and the securities industry. They are developing ways of working very well together.

The whole pooling concept addresses the issue of tapping that vast institutional marketplace and the injection of the Federal Financing Bank as the ultimate investor really destroys that loop. It is my very strong feeling that the ultimate benefits to the small business borrower would not be enhanced by that action.

Mr. SCHIFFER. I would be very much opposed to it.

Mr. OLIN. That's not needed, then.

One of the things I have wondered about in this situation, I understand that the administration is very lukewarm on this proposal. Do you have any idea why they might be, and would you be willing to comment on that?

Mr. SCHIFFER. I'll do it.

Mr. OLIN. Anybody.

Mr. SCHIFFER. I would say, offhand, that it is probably at this point, with all due respect, a lack of understanding of the potential. If somebody ever did the math on some of what I call the insurance idea of pooling, instead of looking at the bottom line, which included the social programs of GNMA and similar things, I think that you would be quite surprised. I can't imagine anyone being anti-black bottom line.

Mr. OLIN. You wouldn't think so.

Mr. Watson.

Mr. WATSON. I think there is some confusion in this bill, in that in my way of thinking, it is not an appropriations issue; it's an issue of efficiency, given whatever the appropriations and existing activities are. So in that regard, greater efficiency and lower cost to the ultimate borrower is the end result of this and not any type of ballooning of the budget. Therefore, I don't see any real validity in opposing this issue.

Mr. OLIN. Mr. Jones, do you have any comment on that?

Mr. JONES. I know there has been a continuing concern with Government assuming private-sector roles, and in this particular instance it seems to me this would be a beautiful example of Government getting the private sector to take a role that really was nonexistent before. So it is a beautiful example of getting Government and the private sector to work together, with the end result being that the small business community gets capital at a lower rate and the overall economy benefits from that. I can't see anything wrong with that.

Mr. OLIN. I am hopeful that the SBA will be successful in convincing the administration to alter its bias there a little bit.

Well, I think we have covered the ground, unless any of you have anything additional to comment on. I really appreciate your coming today. The testimony has been good. Your prepared statements will go in the record.

Some of the committee members may want to send you questions in writing. I presume you would be willing to respond in that event. We will keep the record open for those possible further questions from the chairman or other members.

Thank you very much for attending. The meeting is adjourned.

[Whereupon, at 11:08 a.m., the subcommittee adjourned, to reconvene subject to call of the Chair.]

98TH CONGRESS
2D SESSION

H. R. 4773

To amend the Small Business Act to assist in the creation of a secondary market for the portions of loans guaranteed by the Small Business Administration.

IN THE HOUSE OF REPRESENTATIVES

FEBRUARY 7, 1984

Mr. NOWAK (for himself, Mr. WILLIAMS of Ohio, Mr. MITCHELL, Mr. BEDELL, Mr. SMITH of New Jersey, Mr. ECKART, Mr. VANDERGRIFF, Mr. DREIER, Mr. ROEMER, Mr. SKELTON, Mr. LAFALCE, Mr. OLIN, and Mr. BRITT) introduced the following bill; which was referred to the Committee on Small Business

A BILL

To amend the Small Business Act to assist in the creation of a secondary market for the portions of loans guaranteed by the Small Business Administration.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) section 5 of the Small Business Act is amended by adding at the end thereof the following new subsection:

"(f)(1) The Administrator may, upon such terms and conditions as the Administrator may deem appropriate, guarantee the timely payment of the principal of and interest on such trust certificates or other securities as shall—

"(A) be issued by any person approved for purposes of this subsection by the Administrator, and

"(B) be based on and backed by a trust or pool composed of the portions of deferred participation loans and guaranteed loans which have been guaranteed by the Administration under this Act or title V of the Small Business Investment Act of 1958.

"(2) Such trust certificates or other securities shall have such terms, conditions, and maturities, and bear such rate of interest, as the Administrator shall determine.

"(3) The full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under any guarantee under this subsection.

"(4) The Administrator shall collect from the issuer a reasonable fee for any guarantee under this subsection and shall make such charges as he may determine to be reasonable for the analysis of any trust or other security arrangement proposed by the issuer.

"(5)(A) In the event the issuer is unable to make any payment of the principal of or interest on any certificate or security guaranteed under this subsection, the Administrator shall make such payment as and when due in cash, and thereupon shall be subrogated fully to the rights satisfied by such payment.

"(B) The Administrator may, in connection with any guarantee under this subsection, whether before or after any default, provide by contract with the issuer for the extinguishment, upon default by the issuer, of any redemption, equitable, legal, or other right, title, or interest of the issuer in any loan portion constituting a portion of the trust or pool against which the guaranteed certificates or securities are issued.

"(C) With respect to any issue of guaranteed certificates or securities, in the event of default and pursuant otherwise to the terms of the contract, the portions of the loans which constitute such trust or pool shall become the absolute property of the Administration subject only to the unsatisfied rights of the holders of such loan portions.

"(D) No State or local law, and no Federal law, shall preclude or limit the exercise by the Administration of—

"(i) its power to contract with the issuer on the terms contained in subparagraph (B),

"(ii) its rights to enforce any such contract with the issuer, or

"(iii) its ownership rights, as provided in subparagraph (C), in the portions of loans constituting the trust or pool against which the guaranteed certificates or securities are issued.

"(6) The Administrator shall develop such procedures as are necessary for the facilitation, administration, and promotion of secondary market operations.".

500 East Eighth Avenue
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Colorado Housing Finance Authority

February 23, 1984

The Honorable Henry J. Nowak, Chairman
Subcommittee on Tax, Access to Equity
Capital and Business Opportunity
House Small Business Committee
B363 Rayburn Building
Washington, D.C. 20515

Dear Congressman Nowak:

I am writing to offer my thoughts as you convene hearings on the relationships between SBA loan guarantees and the secondary market. I ask that my comments be included as a part of the permanent record of those hearings.

The issue to which I devote my testimony is the current SBA policy which, except for certain limited cases, prohibits penalties in connection with the prepayment of SBA guaranteed loans. While I understand that this policy is intended to minimize barriers to prepayment of these guaranteed loans and allows guarantee authority to be reallocated, it has severe negative effects on small business borrowers in the current volatile interest rate climate.

While recent SBA studies have suggested that lenders may realize significant profits by selling the guaranteed portion of loans to secondary market purchases, the secondary market as presently constituted does little to improve the quality of capital available to the small borrower. This is because secondary market investors, like lenders, expect protection from interest rate risk and normally buy only loans bearing variable interest rates. In a climate where the prime rate changed over 100 times during a one-year period from mid 1981 to mid 1982 many SBA borrowers found the rates on their loans doubling from about 12% to over 25%. For many this increase in interest expense has been an intolerable burden.

The opportunity that SBA and the small business borrower are missing with a policy prohibiting prepayment penalties is the ability to tap the last remaining market offering fixed price, long-term capital -- the bond markets. Investors in this market, because of the way the bond pricing mechanism works, will accept interest rate risk. The type of risk they are reluctant to accept is reinvestment risk. When bonds are called before maturity investors require a bond call premium.

It would be relatively straightforward process for our agency to develop a secondary market to supply fixed rate, long-term capital to small business borrowers using the proceeds of taxable bonds except for the problem of paying bond call premiums in the event of loan prepayment. Allowing for prepayment penalties would solve this obvious and unnecessary barrier to capital access.

I urge the committee to address this problem since the recent volatility of interest rates has made the problems of financing a small business even more difficult. The purpose of SBA guarantees is to assist small businesses to raise capital. In the new economy and financial markets we are developing in this country small business, if it is to be healthy, should have access to fixed-rate capital. This could easily be done by permitting prepayment penalties and could have the added benefit of improving the performance of the SBA guarantee portfolio by putting its borrowers on a more stable, predictable and less risky financial footing. I urge you to encourage the SBA to adopt a more flexible policy regarding prepayment penalties on SBA guaranteed loans.

Sincerely,

COLORADO HOUSING FINANCE AUTHORITY

Craig Archibald
Director of Commercial Programs

CA:tmw

cc: Dan Schaefer

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Independent BANKERS ASSOCIATION OF AMERICA

WASHINGTON OFFICE

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March 1, 1984

Honorable Henry J. Nowak
Chairman
Subcommittee on Tax, Access to Equity,
Capital, and Business Opportunities
U.S. House of Representatives
B-363 Rayburn House Office Bldg.
Washington, D.C. 20515

Dear Mr. Chairman:

In response to your invitation, I am writing in regard to your bill H.R. 4773, to improve the secondary marketing of SBA guaranteed loans, on which you held hearings February 29. The IBAA supports the enactment of H.R. 4773.

The IBAA's resolutions call for Congress and the Administration "to strengthen guaranteed loan program authorizations wherever guaranteed loans have proven effective, and to make such loan guarantees as workable and reliable as possible for borrowers and lenders." By providing for the pooled sale of SBA guaranteed loans and otherwise encouraging the secondary marketing of guaranteed loans, H.R. 4773 should strengthen the SBA loan guarantee program.

Guarantees by the Small Business Administration can be useful in channelling funds to small businesses which may have difficulty competing for adequate credit. A government loan guarantee can increase the capacity of independent banks to serve small business borrowers because the guaranteed loan is readily salable in secondary markets, does not generally apply against the legal lending limit of the banks, and may render certain loans less subject to a substandard classification by the bank regulators. The sale of guaranteed loans in the secondary market enables a flow of funds into fund-deficient areas to finance local enterprises. The marketing of guaranteed loans to secondary investors can also enable local institutions to extend longer term credit to businesses.

In the pooling of SBA guaranteed loans as provided in H.R. 4773, the pooling arrangements should in all cases accomodate individual loans or very small numbers of loans from originating banks, so that smaller banks which originate smaller numbers of SBA loans are not bypassed in this process. Small businesses which are widely dispersed throughout the local communities of the country will be best served by making sure that all local community banks can readily use the secondary market even though their loan volume may not be large.

Sincerely,

James D. Herrington

James D. Herrington
President